Supreme Court, U.S.
FILED
APR 24 2002
OFFICE OF THE CLERK

No. 01-1209

In The

Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, AND BOEING SALES CORPORATION,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ of Certiorari To The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF BRUNSWICK CORPORATION, HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, AND REEBOK INTERNATIONAL LTD. IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

C. DAVID SWENSON
Counsel of Record

BAKER & MCKENZIE
815 Connecticut Avenue, N.W.
Washington, D.C. 20006-4078
(202) 452-7011

APRIL 24, 2002

Counsel for Amici Curiae

26pp

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES..... ii

INTEREST OF THE AMICI CURIAE..... 1

STATEMENT 6

SUMMARY OF ARGUMENT..... 10

REASONS FOR GRANTING THE WRIT 11

I. THE DIRECT CONFLICT IN THE CIRCUITS CREATES INHERENT UNFAIRNESS AND INEQUITIES..... 11

II. THE DECISION BELOW FRUSTRATES TWO VITAL NATIONAL POLICIES: ENCOURAGEMENT OF R&D EFFORTS, AND STIMULATION OF EXPORT ACTIVITIES..... 14

A. The Ninth Circuit Decision Increases the Costs of Conducting Critical R&D Activities. 14

B. The Ninth Circuit Decision Significantly Dilutes an Important Export Incentive. 16

CONCLUSION 20

TABLE OF AUTHORITIES

CASES **Page**

Caterpillar Tractor Co. v. United States, 589 F.2d 1040 (Ct. Cl. 1978) 18

Snow v. Commissioner, 416 U.S. 500 (1974) 14

St. Jude Medical Inc. v. Commissioner, 34 F.3d 1394 (8th Cir. 1994) 7, 8, 10, 11, 18

FEDERAL STATUTES AND REGULATIONS

Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494 ..... 7, 15,17

Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000) 7, 17

Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 ..... 7, 17

Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686 15

Tax Reform Act of 1984, Pub. L. 98-369 15

Tax Reform Act of 1986, Pub. L. No. 99-514, § 231(1), 100 Stat. 2055 15

Tax Relief Extension Act of 1999, Pub. L. No. 105-277, § 1001 15

TABLE OF AUTHORITIES – Continued

Page

26 U.S.C.:

§ 41 6
§ 109 (1939) 7
§ 174(a) 6, 14
§ 921 (1954) 7, 17
§ 922 (1954) 7, 17
§ 927(d)(2)(B) (1984) 19
§ 943(b)(1)(B) (2000) 19
§ 994(a) 8
§ 994(b)(2) 8
§ 6213(a) 5
§ 7482(b)(1)(B) 5

28 U.S.C.:

§ 1205(a)(3) 5, 6
§ 1294(1) 5
§ 1346(a)(1) 5, 6

Treasury Regulations:

§ 1.861-8(e)(3) 7, 9
§ 1.994-1(c)(6)(iii) 8, 9
§ 1.994-1(c)(6)(iv) 9
§ 1.994-1(c)(7) 10
§ 1.994-1(c)(7)(i) 8, 9
§ 1.994-1(c)(7)(ii) 9

TABLE OF AUTHORITIES – Continued

Page

LEGISLATIVE HISTORY

General Explanation of the Economic Recovery Tax Act of 1981,Joint Committee on Taxation, H.R. 4242 97th Cong., 1st Sess. 119 (1981)..... 14

Hearings Before the House Committee on Ways and Means on the WTO's Extraterritorial Income Decision (February 27, 2002)..... 18

H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971)..... 8, 9, 12, 18, 19

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28 (1954)..... 14

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77 (1954)..... 7

S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 904 (1984) 15

S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971) 17, 18

S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954)..... 14

S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954)..... 7

S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942)..... 7, 17

TABLE OF AUTHORITIES – Continued

Page

MISCELLANEOUS

Actions on Decision

AOD 1995-2 C.B. 2 (1995)..... 13

AOD 1999-2 C.B. xvi-xvii (1999) 13

AOD 1995-001 (February 13, 1995)..... 13

AOD 1999-005 (August 30, 1999)..... 13

Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules, Joint Committee on Taxation (JCX-10-02) 10, February 25, 2002..... 19

United States--Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001 17

In The

Supreme Court of the United States

No. 01-1209

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, AND BOEING SALES CORPORATION,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ of Certiorari To The United States Court of Appeals For The Ninth Circuit

BRIEF *AMICI CURIAE* OF BRUNSWICK CORPORATION, HEWLETT-PACKARD COMPANY, INTEL CORPORATION, KLA-TENCOR CORPORATION, AND REEBOK INTERNATIONAL LTD. IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

INTEREST OF THE *AMICI CURIAE*

Amici Curiae are five publicly held United States corporations representing a broad spectrum of industries,[1] including marine engines, recreational watercraft, imaging and printing systems, computing systems, information technology services, microprocessors, chipsets, sports and fitness products, semiconductor and microelectronics testing equipment, data storage devices, and athletic footwear and apparel products. Each company engages in significant research and development ("R&D") activities and is profoundly interested in the export laws of the United States and the tax incentives enacted by Congress.

[1] All parties to this proceeding have consented to the submission of this brief in letters of consent filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae*, made a monetary contribution to the preparation or submission of this brief.

Amici curiae are adversely affected by a decision of the United States Court of Appeals for the Ninth Circuit that interprets the application of a Treasury regulation in direct and irreconcilable conflict with a 1994 decision in the Eighth Circuit. This conflict alone warrants this Court's exercise of jurisdiction to ensure uniform treatment in the administration of our nation's federal tax laws. Inevitable and continued litigation over the Treasury regulation at issue is virtually certain, with the attendant consequence that taxpayers will be treated differently depending on the venue of adjudication. This type of conflict is corrosive to the confidence that all citizens must have in the administration of our federal tax system. This Court should grant the petition, rather than allow the conflict to continue among the courts of appeals to the detriment of the *amici curiae* and hundreds of other similarly situated taxpayers.

Brunswick Corporation ("Brunswick") is incorporated in the State of Delaware, with its principal executive offices located in Lake Forest, Illinois. Brunswick is a leading manufacturer and marketer of marine engines, recreational watercraft, fitness and exercise equipment, and bowling and billiards products. Brunswick produces many of its products at manufacturing plants in the United States, and sells those products in the domestic market and worldwide directly to original equipment manufacturers and through distributors and dealers. Brunswick's sales to customers in international markets exceeded $835 million in 2000. R&D activities are important to maintaining and expanding Brunswick's product lines. Brunswick's growth strategies include investing in leading-edge technologies and innovative products. In 2000, Brunswick's R&D investments relating to new products and the improvement of existing products exceeded $100 million.

Hewlett-Packard Company ("HP") is incorporated in the State of Delaware, with its principal executive offices located in Palo Alto, California. HP is a leading global provider of business and home products in its three major business segments: Imaging and Printing Systems, Computing

Systems, and Information Technology Services. HP is the world's largest imaging and printing systems provider for printer hardware, printing supplies and scanning devices. HP Computing Systems products include commercial and home personal computers ("PCs"), UNIX servers, PC servers, storage and software solutions. The Information Technology Services segment provides leading customer support, consulting, outsourcing and other services that allow customers to take advantage of emerging technologies and business models. The markets for HP's three principal business segments are characterized by short product life cycles and require the vigorous development of new and enhanced products and services. Hewlett-Packard Laboratories ("HP Labs"), together with the efforts within the three principal business segments, conduct R&D to provide a continuing flow of innovative, high-quality products and services and to enhance current product offerings. Expenditures for R&D in fiscal 2001, including HP Labs and the three principal business segments, were $2,700 million. HP's research, product development, and manufacturing are conducted in the United States and in numerous locations throughout the world. HP maintains operations in more than 120 countries worldwide and sells products and services into additional locations through various representatives and distributors.

Intel Corporation ("Intel") is incorporated in the State of Delaware, with its principal executive offices located in Santa Clara, California. Intel supplies the basic building blocks and ingredients of computer architecture and the internet economy. Intel is the world's largest semiconductor chip maker, and its products include microprocessors, which control the central processing of data in personal computers, servers, workstations, and other devices; chipsets, which perform essential logic functions surrounding the central processing units in computers based on Intel architecture processors; and embedded control chips for automobile engines and breaking systems, hard disk drives, cellular

phones, and laser printers. Intel's competitive position has developed in large measure because of its emphasis on R&D activities. In 2000, Intel's R&D expenditures totaled $3,897 million, and were devoted to the development of new products, as well as the enhancement of existing products. Intel's products are produced in the United States and in numerous locations abroad, and are sold for use in countries throughout the world.

KLA-Tencor Corporation ("KLA-Tencor") is incorporated in the State of Delaware, with its principal executive offices located in San Jose, California. KLA-Tencor was formed in April 1997 through the merger of KLA Instruments Corporation and Tencor Instruments, two long-time participants in the semiconductor equipment industry. KLA-Tencor is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. KLA-Tencor sells a broad spectrum of semiconductor equipment products designed to assist integrated circuit manufacturers manage yield throughout the wafer fabrication process from the research and development phase to final mass production yield analysis. The markets served by KLA-Tencor are characterized by rapid technological development and product innovation. Accordingly, KLA-Tencor devotes a significant portion of its human and financial resources to R&D programs, and is committed to significant engineering efforts toward product improvement and new product development. The company's global customer base includes virtually every major semiconductor manufacturer in the world, and its products are sold throughout the United States, Europe, Asia-Pacific, and Japan.

Reebok International Ltd. ("Reebok") is incorporated in the Commonwealth of Massachusetts, and its principal executive offices are located in Canton, Massachusetts. Reebok is a global company, engaged primarily in the design and marketing of sports and fitness products. Reebok is one of the world's leading companies engaged in the design,

marketing, and distribution of sports, fitness, and casual footwear, apparel and equipment under the Reebok, Rockport, and Greg Norman brands, and footwear under the Polo Ralph Lauren brand. Reebok engages in product R&D and design activities at its product development facilities. R&D activities are integral to the company's success. Reebok places strong emphasis on technology and incorporates various proprietary performance technologies in its products. Reebok sells its products throughout the United States and in approximately 170 countries and territories worldwide. Reebok footwear and apparel products are distributed in the United States primarily through athletic retailers, sporting goods stores, and department stores. Reebok's sales outside the United States are conducted through its international distribution network, consisting of related entities and independent distributors around world.

On a cumulative basis, the *amici curiae* produce thousands of products in a wide variety of industries. Those products are sold in markets throughout the world. Individually, each company conducts substantial R&D activities and is vitally interested in the tax incentives granted by Congress. The Ninth Circuit decision below jeopardizes those incentives and the *amici curiae* submit that it is essential for this Court to review and resolve the fundamental issue presented in this proceeding.

The *amici curiae* are located throughout the United States. In federal income tax cases, one or more of the *amici curiae* are subject to the appellate jurisdiction of the courts of appeals of the First, Seventh, Ninth, or Federal Circuits. *See* 26 U.S.C. § 7482(b)(1)(B), 28 U.S.C. § 1294(1), 28 U.S.C. § 1205(a)(3).[2] The potential adverse implications of the

[2] Taxpayers have the option in most cases to bring an action relating to a federal income tax issue in the United States Tax Court or the appropriate United States District Court. *See* 26 U.S.C. § 6213(a), 28 U.S.C. § 1346(a)(1). In certain cases, taxpayers also have the option to bring a refund suit in the United States Court of Federal Claims. *See* 28 U.S.C. § 1346(a)(1). Appellate jurisdiction for tax cases decided by the United

decision below are obvious for the *amici curiae* subject to the appellate jurisdiction of the Ninth Circuit (*i.e.*, HP, Intel, and KLA-Tencor).[3] The *amici curiae* subject to the appellate jurisdiction of other courts of appeals (*i.e.*, Brunswick and Reebok) are disadvantaged by the uncertain results from the present split in the Eighth and Ninth Circuits. Only this Court can eliminate that uncertainty and ensure a uniform rule for all taxpayers.

The *amici curiae* appear in this proceeding to enhance the Court's understanding of two important matters. First, the decision below and the conflict in the courts of appeals create unwarranted inequities and unfairness among similarly situated taxpayers. Second, the Ninth Circuit decision frustrates two policies of profound national interest: encouragement of innovative R&D activities, and stimulation of exports from the United States.

STATEMENT

This proceeding involves an issue of fundamental importance involving R&D activities and export tax incentives. Commencing in 1954, Congress provided tax incentives to encourage R&D activities by United States businesses. *See, e.g.*, Internal Revenue Code §§ 41, 174(a).[4] During the last sixty years, Congress has also enacted four separate tax regimes designed to stimulate and increase the export of products from the United States.[5] The taxable

States Court of Federal Claims lies with the United States Court of Appeals for the Federal Circuit. *See* 28 U.S.C. § 1205(a)(3).

[3] Although taxpayers subject to the appellate jurisdiction of the Ninth Circuit may be able to bring a tax refund suit in the United Sates Court of Federal Claims (*see* 28 U.S.C. § 1346(a)(1)), their Tax Court and district court options are curtailed, if not foreclosed, by the decision below.

[4] References to sections of the Internal Revenue Code (26 U.S.C.) are to the Internal Revenue Codes of 1954 and 1986, as amended and in effect for the years at issue, unless otherwise stated.

[5] In 1942, Congress provided export tax incentives to "Western Hemisphere Trade Corporations." *See* Internal Revenue Code of 1939 §

years at issue in the matter before the Court involve two of those regimes, namely the Domestic International Sales Corporation ("DISC") provisions, and the Foreign Sales Corporation ("FSC") provisions.[6]

The specific question presented in this proceeding concerns the application of a Treasury regulation[7] to the computation of export sales income under the DISC and FSC provisions of the Internal Revenue Code (26 U.S.C.). In 1994, the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) (relating to the allocation of R&D expenses) was unreasonable and invalid when applied to the calculation of income under the DISC regime. *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394, 1396 (8th Cir. 1994). Seven years later, the court of appeals below reached the opposite conclusion on virtually identical facts.

Simply stated, the issue in this proceeding is whether, for purposes of calculating export benefits under the DISC regime, taxpayers must allocate R&D expenses to extremely

109; Internal Revenue Code of 1954 §§ 921-922 (prior to repeal); S. Rep. No. 1631, 77th Cong., 2d Sess. 32, 111 (1942); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954). In 1971, Congress granted export tax incentives for "Domestic International Sales Corporations." *See* Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497. The "Foreign Sales Corporation" regime was enacted in 1984. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494. Most recently, export incentives were enacted in the Extraterritorial Income Exclusion Act of 2000. *See* Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000).

[6] In the proceeding below, the parties agreed that for purposes of the issue in the present case there are no significant differences between the DISC and FSC regimes. *See* Pet. at 3, n.2; Pet. App. B. at 20a, n.2. References to "Pet." or "Pet. App." are to Petitioners' Petition For a Writ of Certiorari, and the Appendices thereto, in this proceeding (No. 01-1209). For convenience, the discussion herein is based only on the DISC provisions, unless the context requires otherwise.

[7] References to sections of the regulations are to the Department of Treasury regulations, as published in 26 Code of Federal Regulations, and as in effect during the years at issue, unless otherwise stated.

broad product categories (such as "transportation equipment"), or whether taxpayers have an undeniable right to allocate R&D expenses to more narrow product groups to which the expenses "directly relate." The Ninth Circuit below held that taxpayers are required to allocate R&D expenses to broad product categories, even if those expenses *do not* directly relate to the export sales. *See* Pet. App. A, at 13a. Conversely, the Eighth Circuit held the Treasury regulations provide taxpayers a right to choose recognized product or product line groups and to allocate R&D expenses to those specific product groups. *See St. Jude Medical,* 34 F.3d at 1396.

Under the DISC tax incentive regime, Congress allowed taxpayers to select one of three pricing methods to compute the maximum tax benefit from export activities. *See* I.R.C. § 994(a). The particular pricing approach at issue in this proceeding is the "combined taxable income" method ("CTI"), which is a net income concept calculated by determining gross export sales receipts and subtracting costs (including R&D costs) from those receipts. *See* I.R.C. § 994(b)(2). The legislative history to the DISC regime provides that CTI is determined by deducting expenses "directly related" to the production or sale of export property, and a portion of the expenses not allocable to "any specific item of income." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The regulations follow this legislative intent and provide that costs treated as relating to export gross receipts are those that are "definitely related" to the export sales, and a ratable part of other expenses not definitely related to a class of gross income, "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii).

For purposes of computing export income qualifying for the DISC incentive, the computations can be made on a "transaction-by-transaction basis." Treas. Reg. § 1.994-1(c)(7)(i). As an alternative to transaction-by-transaction determinations, Congress intended to provide, and the

regulations grant, taxpayers the right to "group" transactions on the "basis of groups consisting of products or product lines." *Id.; see* H.R. Rep. No. 533, *supra*, at 74. The regulations further provide that the taxpayer's grouping choice "will be accepted" if it conforms with either (i) "recognized industry or trade usage," or (ii) "the two-digit major groups" of the Standard Industrial Classification ("SIC") manual, issued by the Office of Management and Budget. Treas. Reg § 1.994-1(c)(7)(ii). The regulations also provide that the taxpayer's choice "shall be controlling," and costs "shall be allocated and apportioned to the items or classes of gross income***resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

These regulatory provisions establish basic principles in computing income subject to the DISC export incentives. First, a taxpayer is granted the right to "group transactions" on the basis of specific "products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). Second, the taxpayer's grouping choice "will be accepted" if it conforms to a recognized industry or trade usage standard. Treas. Reg. § 1.994-1(c)(7)(ii). Assuming the choice conforms to such standard, the taxpayer's grouping "shall be controlling" and costs shall be allocated and apportioned to those groups. Treas. Reg. § 1.994-1(c)(6)(iv). Finally, costs "directly related" to those groups shall be allocated thereto, and costs directly related to non-export classes of income shall not be allocated to export sales. *See* Treas. Reg. § 1.994-1(c)(6)(iii).

The Treasury regulation relating to the allocation or apportionment of R&D expenses (Treas. Reg. § 1.861-8(e)(3)) directly conflicts with the DISC legislative history and the DISC regulations. Under Treas. Reg. § 1.861-8 (e)(3), R&D expenses are allocated or apportioned to all products falling within broad two-digit categories, as enumerated in the SIC manual. Expenses are allocated to the broad SIC code categories regardless of whether the costs have any direct relationship to those categories. To the extent this regulation allocates R&D expenses to broad

product categories that have *no* direct or definite factual relationship to the specific products or product lines chosen by the taxpayer, the provision is directly contrary to the DISC statute, legislative history, and regulations. Consequently, as applied to such DISC determinations, Treas. Reg. § 1.861–8(e)(3) is unreasonable and invalid. *See St. Jude Medical*, 34 F.3d at 1396.

Petitioners followed the applicable regulatory rules and chose to "group transactions" on the basis of specific product lines under recognized industry or trade usage, and not on the basis of the broad two-digit SIC code category relating to "transportation equipment."[8] Despite the clear regulatory scheme, the Ninth Circuit found Petitioners were required to use the broad two-digit SIC code classification category, rather than the specific product lines selected by Petitioners pursuant to the right envisioned by Congress and granted under Treas. Reg. § 1.994-1(c)(7). Petitioners had an undeniable right to use the more specific product categories instead of the broad classifications imposed by the invalid Treasury regulation. *See St. Jude Medical,* 34 F.3d at 1396.

SUMMARY OF ARGUMENT

This case presents an irreconcilable conflict in the circuits which is unusually harsh because it creates unfairness among similarly situated taxpayers across the United States. Taxpayers located in one part of the country (subject to the appellate jurisdiction of the Eighth Circuit) receive the benefits intended by Congress in fostering R&D activities and providing export incentives. Taxpayers located in a different part of the country (subject to the appellate jurisdiction of the Ninth Circuit) are denied the full measure of those benefits. Taxpayers located in still other parts of the country must endure uncertainty and confront the possibility of lengthy and expensive audits and litigation with the

[8] There is no disagreement that each of the product lines selected by Petitioners "constituted a separate product or product line under industry practice and trade usage." *See* Pet. App. A, at 2a; Pet. App. B, at 16a.

Internal Revenue Service ("IRS"). It is patently unfair for one set of taxpayers to be deprived of the full benefit of the export incentives provided by Congress, while other taxpayers receive their entitlement to those benefits.

The Ninth Circuit decision frustrates national policies encouraging R&D activities and granting export incentives. In a perverse way, the decision below imposes a financial penalty on companies conducting valuable R&D activities, and denies the benefits of the export tax incentives promised by Congress, thereby directly impeding Congress' goal of increasing exports.

The decision by the court of appeals leads to negative practical consequences. The Ninth Circuit decision increases the costs of conducting innovative activity, undermines financial incentives to operate manufacturing plants in the United States and could lead to the loss of employment, increases our trade deficit dilemma, and places United States companies at a global competitive disadvantage *vis-à-vis* companies located abroad. Prompt review by this Court is appropriate and necessary.

REASONS FOR GRANTING THE WRIT

I. THE DIRECT CONFLICT IN THE CIRCUITS CREATES INHERENT UNFAIRNESS AND INEQUITIES.

This case presents a direct conflict in the courts of appeals on a key question of federal law. In *St. Jude Medical*, the Court of Appeals for the Eighth Circuit held that Treas. Reg. § 1.861-8(e)(3) "is invalid as applied to DISC CTI computations." *St. Jude Medical,* 34 F.3d at 1396. In the decision below, the Court of Appeals for the Ninth Circuit found the same provision to be valid as "a reasonable interpretation of the applicable statutes and regulations." Pet. App. A, at 13a. The two cases are indistinguishable in all material respects and the conflict between the circuits is clear, direct, and indisputable.

The conflict involves a significant matter and raises a fundamental question relating to the encouragement of R&D activities and United States international trade policy. The relevant provisions of the Internal Revenue Code (26 U.S.C.) relating to R&D activities were enacted to encourage companies to engage in innovative research efforts. *See* Ways and Means Committee Rept., H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28, 57 (1954). The DISC provisions were enacted to provide incentives for United States companies to increase their exports to other countries. *See* H.R. Rep. No. 533, *supra*, at 58. The conflict in the circuits directly implicates these vital national policies designed to ensure United States companies are able to compete on a fair and balanced level in the world trade arena. The courts of appeals are irreconcilably divided on this important question and the issue should be resolved by this Court.

Although the direct conflict in the circuits, standing alone, warrants consideration by this Court, the need for immediate review is particularly acute here because the conflict creates inherent unfairness and inequities. It is inequitable to allow a company in one geographic location to receive the full benefits of its R&D expenditures, while simultaneously penalizing companies incurring those same costs located in other geographic locations. In the Ninth Circuit, R&D expenditures not directly related to export sales inappropriately reduce the value of export tax incentives granted by Congress. In the Eighth Circuit, the identical R&D expenditures do not reduce those export incentives. The decision below creates an inequitable penalty for companies engaged in R&D activities *unrelated* to the sale of export property.

The Ninth Circuit decision significantly dilutes the value of historically important export incentives. Those incentives were provided by Congress without regard to the geographic location of the taxpayer in the United States. It is unfair to deprive taxpayers located in one part of the country the

export benefits promised by Congress and allow taxpayers located in a different part of the country to receive their entitlement to those benefits. Under the rule adopted by the court below, competitors in different locations bear significantly different tax liabilities with respect to their export activities. The conflict in the courts of appeals results in this unfairness and necessitates immediate review by this Court.

Finally, the conflict in this proceeding presents an issue that will continue to arise in a significant number of cases across the country. In 1995, and again in 1999, the IRS nonacquiesced[9] in the Eighth Circuit decision in *St. Jude Medical*. *See* Actions on Decisions, 1995-2 C.B. 2 (1995), 1999-2 C.B. xvi-xvii (1999); IRS AOD 1995-001 (February 13, 1995); IRS AOD 1999-005 (August 30, 1999). In the second action on decision, the IRS stated that it "will continue to litigate our position in the other circuits." IRS AOD 1999-005 (August 30, 1999). Following *St. Jude Medical*, and the nonacquiescence in that decision, the IRS challenged Petitioners' computation of CTI and attempted to convince another court of appeals to reach a different conclusion. The IRS was successful in the court below and the IRS is likely to rely on the Ninth Circuit decision to challenge taxpayers across the nation.[10]

This threat of litigation creates immediate uncertainty for companies engaged in critically important R&D efforts and export activities. Further, for companies considering the

---

[9] In reference to an opinion by a circuit court of appeals, the term "nonacquiescence" signifies that although the IRS recognizes the precedential impact of the opinion on cases arising within the venue of the deciding circuit, the IRS will not follow the holding on a nationwide basis. *See* Actions on Decision, 1999-2 C.B. xvi (1999).

[10] In the 1995 action on decision in *St. Jude Medical*, the IRS stated that the "issue should continue to be litigated and/or defended since it also arises in the context of *** Foreign Sales Corporations ***." IRS AOD 1995-001 (February 13, 1995).

advantages of commencing or expanding export activities in the United States, the decision below creates a serious deterrent to such efforts. This case presents an important reoccurring issue, and there is nothing to be gained by postponing this Court's consideration of the overarching question.

II. THE DECISION BELOW FRUSTRATES TWO VITAL NATIONAL POLICIES: ENCOURAGEMENT OF R&D EFFORTS, AND STIMULATION OF EXPORT ACTIVITIES.

A. The Ninth Circuit Decision Increases the Costs of Conducting Critical R&D Activities.

R&D activities represent the innovative forces necessary for the development of new products and technologies and for maintaining and enhancing existing products. National policies have existed for at least forty-eight years providing tax benefits to encourage taxpayers to carry on R&D activities. In 1954, Congress enacted a special provision in the Internal Revenue Code granting taxpayers an election to deduct currently R&D expenditures. *See* I.R.C. § 174(a). This election was granted to "encourage taxpayers to carry on" R&D activities. *See* H.R. 8300, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954); *Snow v. Commissioner,* 416 U.S. 500, 504 (1974).

In 1981, Congress expressed concern over our nation's decline in R&D activities and concluded that "spending for these purposes had not been adequate." *See* General Explanation of the Economic Recovery Tax Act of 1981, Joint Committee on Taxation, H.R. 4242, 97th Cong., 1st Sess. 119 (1981). To reverse the decline in R&D spending, Congress decided that a tax credit for incremental R&D expenditures was needed "to overcome the reluctance" to bear costs needed to "initiate or expand research programs." *Id.* at 120. In response, Congress enacted a new provision of the Internal Revenue Code (currently, I.R.C. § 41) allowing

an income tax credit for certain qualified research expenditures incurred by a taxpayer in carrying on a trade or business.[11] The purpose of the credit was to "encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy." Deficit Reduction Act of 1984 (Pub. L. No. 98-369), S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 904 (1984).[12] This history of legislative action reflects a strong national policy for almost fifty years encouraging United States taxpayers to engage in R&D activities designed to enhance existing products and create new products and technologies.

The R&D incentives in the Internal Revenue Code have encouraged the development of many existing and new innovative products and industries. Each of the a*mici curiae* engages in significant R&D activities in its respective markets. Those activities are vitally important to the world class positions the *amici curiae* have attained in their industries. The court of appeals decision below frustrates this key national policy because it increases the financial cost for companies engaging in R&D activities that could yield unsuccessful products, products sold only in the domestic market, or products otherwise *unrelated* to export income.

Under the Ninth Circuit decision, every dollar of R&D expenditures *unrelated* to export receipts creates a financial disadvantage for companies to the extent allocated or

---

[11] The R&D credit was originally enacted as I.R.C. § 44F, but was subsequently renumbered as I.R.C. § 30 (*see* Tax Reform Act of 1984, Pub. L. 98-369), and most recently as I.R.C. § 41 (*see* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085).

[12] An expiration date for the R&D credit was deemed desirable to enable Congress to evaluate the experience with the credit, and to "determine whether it should be extended***." S. Prt. No. 169, *supra,* at 904. The credit has been extended numerous times since 1981. *See, e.g.,* The Tax Extension Act of 1991, Pub. L. No. 102-227, 105 Stat. 1686. In 1999, Congress extended the R&D credit through June 30, 2004 in the Tax Relief Extension Act of 1999, Pub. L. No. 105-277, § 1001.

apportioned to products sold for export under the DISC provisions. Assuming a set of products in the same broad SIC code category, the rule adopted by the Ninth Circuit means that R&D expenses directly related to unsuccessful products not brought to market must be allocated or apportioned to current export income under the DISC provisions. Further, R&D expenditures directly related to products sold only in the domestic market must also be allocated or apportioned to export receipts. Under the reasoning of the court below, every dollar of these R&D expenses reduces the export tax incentives enacted by Congress. This rule applies even though the R&D expenses *are not* factually related to the taxpayer's export products or export income. In essence, the Ninth Circuit decision imposes a financial penalty for engaging in these R&D activities. Such an aberrational result should not stand.

The Ninth Circuit decision imposes a significant financial cost on companies engaging in critical R&D activities, and runs directly counter to historically important policies reflected in legislation enacted by Congress for almost fifty years. The decision below undermines one of our country's most fundamental policies—the encouragement of broad-based R&D activities to create innovative products and to enhance existing products and technologies. The detrimental impact of the decision below on this key national policy warrants immediate review by this Court.

B. The Ninth Circuit Decision Significantly Dilutes an Important Export Incentive.

Congress has been vitally interested in promoting exports through special incentives in the Internal Revenue Code for more than sixty years. [13] One of the earliest export tax incentive regimes was enacted in 1942 for Western Hemisphere trade corporations ("WHTCs"). The WHTC regime was enacted to "alleviate ***competitive inequality."

[13] *See* note 5, *supra*.

S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942). Until 1980, WHTCs enjoyed a fourteen percentage point reduction in the normal corporate tax rate related to exports and business activities conducted in the Western Hemisphere. I.R.C. §§ 921-922 (1954). Commencing in 1971, Congress granted special tax benefits to DISCs to encourage the export of goods manufactured in the United States, and to equalize the taxation of United States companies with the European territorial system. *See* Pub. L. No. 92-178 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). The DISC regime gave rise to complaints from other countries on the basis that it was an export subsidy in violation of the General Agreement on Tariffs and Trade. In 1984, Congress responded to these complaints by replacing the DISC rules with the FSC provisions. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494.

Enactment of the FSC provisions did not deter attacks by other countries on our international trade policies, and in 2000 the World Trade Organization ("WTO") found that the FSC provisions were a prohibited export subsidy. In November 2000, Congress responded by repealing the FSC provisions and enacting a new provision referred to as the extraterritorial income exclusion ("ETI"). *See* Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 106th Cong., 2d Sess. (2000). The European Union filed a new complaint against the ETI provisions and in August 2001 a WTO panel held the new provisions also constituted a prohibited export subsidy.[14] Subsequently, in January 2002, an appellate body of the WTO modified and affirmed the panel's findings.[15] Congress is considering various alternatives for resolving the WTO dispute while continuing

[14] United States–Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

[15] *Id.*, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002.

to provide export incentives so that United States businesses can compete on a fair and level playing field with companies based abroad.[16]

This long history of disputes relating to United States exports, international trade policies, and successive enactments by Congress of export incentives reflects vital national policies. It is in our national interest to encourage the export of products from the United States. Export activities create domestic jobs, facilitate capital investment, encourage construction of plants in our country, improve our balance of payments position, favorably impact interest rates, and support the value of the United States dollar in markets throughout world. Congress has recognized the importance of these national objectives and has sought to provide export incentives to United States businesses continually over a sixty-year period.

Congress specifically enacted the DISC statute to provide tax incentives to increase exports of products produced in the United States and in response to incentives provided by other major trading nations fostering foreign trade and encouraging exports by their domestic producers. *See* S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971); *Caterpillar Tractor Co. v. U.S.*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The FSC and ETI regimes continue this congressional policy of providing incentives to stimulate export activities. In enacting the DISC provisions, Congress provided taxpayers incentives to "maximize DISC profit." *See St. Jude Medical*, 34 F.3d at 1397. In computing the maximum DISC benefit, Congress intended that "directly related" expenses should be allocated to export income. H.R. Rep. No. 533, *supra,* at 74.

[16] *See* Hearings Before the House Committee on Ways and Means on the WTO's Extraterritorial Income Decision (February 27, 2002). It is anticipated that the regulations interpreting the ETI provisions, as well as any subsequent legislation, will also present the issue in this proceeding. Consequently, this issue has continuing importance and relevance from the original DISC legislation, through the FSC and ETI provisions, and the anticipated future legislation in this area.

Congress further intended to grant taxpayers the right to choose groupings by specific product or product lines, and to allocate expenses directly related to those products or product lines. *See* H.R. Rep. No. 533, *supra*, at 74. The Treasury regulations reflect these basic principles, (Treas. Reg. §§ 1.994-1(c)(6)(iii), 1.994-1(c)(7)(i)), and this right to group transactions has been codified in subsequent export legislation.[17]

Contrary to this legislative intent and regulatory scheme, the Ninth Circuit decision requires taxpayers to allocate R&D expenses to broad SIC code categories (rather than the specific product groupings selected pursuant to the right granted by Congress). The approach of the court below requires the allocation or apportionment of entirely *unrelated* R&D expenses to export receipts, thereby significantly diluting the incentives enacted by Congress. The court of appeals decision below is contrary to the congressional intent behind the DISC provisions and frustrates key national policies designed to encourage and increase exports.

The court of appeals decision also leads to negative practical consequences. The DISC regime was enacted to encourage production of export products in the United States, rather than supplying products to customers from overseas locations. *See* H.R. Rep. No. 533, *supra,* at 58. The Ninth Circuit decision reduces the financial advantages of producing products in the United States. Movement of production capacity overseas leads to plant closures and the loss of jobs in United States. Reduction in exports exacerbates our foreign trade deficit, and negatively impacts interest rates in our country and the value of the United States dollar abroad. In an economic environment where our

[17] I.R.C. § 927(d)(2)(B) (1984) (FSC regime), I.R.C. § 943(b)(1)(B) (2000) (ETI regime); *see Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules,* Joint Committee on Taxation (JCX-10-02) 10, February 25, 2002.

nation is struggling to emerge from its first recession in a decade, these are critical practical considerations that emerge from the decision below and justify immediate review by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

C. DAVID SWENSON
Counsel of Record

BAKER & MCKENZIE
815 Connecticut Avenue, N.W.
Washington, D.C. 20006-4078
(202) 452-7011

APRIL 24, 2002 *Counsel for Amici Curiae*